Controller John Chiang
California State Controller's Office

300 Capitol Mall
Sacramento, CA
95814
916.445.2636
www.controller.ca.gov

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Contact: Hallye Jordan
916-445-2636

Chiang Unveils Updated Costs For Funding State Retiree Health Benefits

SACRAMENTO – State Controller John Chiang today released a new report showing the unfunded actuarial accrued liability of providing health and dental benefits for state retirees is projected to be $63.84 billion over 30 years.

"The current pay-as-we-go model of funding retiree health benefits is short-sighted and a recipe for undermining the fiscal health of future generations of Californians," Chiang said. "However, today's challenge won't necessarily become tomorrow's crisis if policymakers can muster the fiscal discipline to invest now so that we can pay tens of billions of dollars less later."

The unfunded obligation as of June 30, 2012, grew $1.70 billion from the $62.14 billion obligation identified as of June 30 2011. The accrued liability grew less than expected due to favorable healthcare claim experiences linked to a combination of fewer claims, less expensive claims, less utilization of services, and the implementation of new California Public Employees' Retirement System's (CalPERS) health programs designed to reduce costs.

While state pensions are pre-funded, allowing investment returns to reduce liabilities, California pays for retiree health benefits on a "pay-as-you-go" basis, or the minimum amount needed to fund the costs as they are due. The latest actuarial report estimates California's obligation for retiree health and dental benefits, also referred to as Other Postemployment Benefits (OPEB), based on two different funding scenarios:

- The current pay-as-you-go policy results in an unfunded actuarial accrued liability of $63.84 billion, which represents the total the State would need to pay for future retiree health benefits earned as of June 30, 2012, by current and future state retirees. Based on this unfunded obligation, California should pay $4.92 billion in 2012-13 to pay for present and future retiree health benefits. In the 2012-13 Budget Act, the State provided $1.81 billion to only cover current retirees' health and dental benefits.
- If the State shifted to fully pre-funding the costs of future benefits, the unfunded actuarial accrued liability would be cut by more than $21.75 billion to $42.09 billion. Under a full pre-funding approach, the State would set aside money in a separate trust solely for future retirement health care benefits. The investment income generated by the trust would be used to reduce the costs to the State and its employees of paying for future benefits. To take advantage of the tremendous cost savings resulting from fully-prefunding, the State would need to contribute $3.51 billion in 2012-13, or $1.70 billion more than the State currently has budgeted.

Recognizing that fully funding the health and dental benefits obligation is unlikely given the State's tight budget, Controller Chiang noted that even incremental steps toward pre-funding the obligation would significantly reduce the State’s liability (see attached chart). For example, if the State pre-funded just 10 percent of its obligation, it would only need to pay $170 million more than its current pay-as-you-go contribution. However, that additional payment would shave $2.74 billion off of the State’s unfunded liability.

Pre-funding 25% of its obligations would cost the State $420 million more than the pay-as-you-go contribution, but would reduce the total unfunded liability by $6.63 billion.

In addition to cutting costs by prefunding the obligation, Chiang said the State should continue to be aggressive in its efforts to contain health care costs by promoting prevention and wellness and innovations in health care delivery. The Controller recommends switching from the traditional fees-for-services payment model to one that pays providers based on performance and outcomes, noting that a pilot program implemented at the California Public Employees’ Retirement System (CalPERS) helped produce $20 million in cost savings. CalPERS is also encouraging members to use surgery centers for certain elective surgeries and generic drugs over brand names to further reduce costs.

On the prevention side, a study commissioned by the Controller found that 22% of CalPERS' expenditures are related to conditions that can be prevented though changes in diet and exercise. Just a 15% reduction in these conditions would result in annual savings of $54 million.

"Improving the health of state employees will not only lead to a more productive workforce, but also to substantial taxpayer savings," Chiang said.

In 2004, the Governmental Accounting Standards Board Statement 45 (GASB 45), *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* required states and local governments to publicly disclose the future costs of paying for post-employment benefits other than pensions for current state retirees and employees. Chiang commissioned California's first report shortly after taking office in 2007.

While GASB 45 does not require states to fully fund their obligations, all three credit rating agencies have urged states to at least have a funding plan in place to avoid any future downgrades.

Prefunding is even more important in the wake of two recently-enacted reporting and accounting rules, GASB 67, *Financial Reporting for Pension Plans* and GASB 68, *Accounting and Financial Reporting for Pensions*. Adopted in 2012, and effective in 2013 and 2014, respectively, the rules require entities to report net pension liability on their financial statements, rather than in footnotes where investors already knew to look. While the goal is to more clearly depict each entity’s financial position the new rule is expected to generate financial statements with diminished bottom lines.

"This provides yet another reason to get our head out of the sand and develop a deliberative process to pre-fund these liabilities," Chiang said. "While the new rules will likely have a negative impact on most balance sheets, the blow can be softened if the State offers a thoughtful plan which demonstrates its ability to fulfill our promise to current and retired public servants in a manner that protects broader taxpayer interests."

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